

Convertible Securities Holder Who Fails to Convert Before Expiration of the Conversion Period

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NOTES

CONVERTIBLE SECURITIES: HOLDER WHO FAILS TO CONVERT BEFORE EXPIRATION OF THE CONVERSION PERIOD

During a four-month period in 1967, the conversion rights of holders of convertible securities having a face value of \$1,313,000 were terminated by redemptions. Since the stock into which these securities could have been converted had a market value of well over three million dollars, the holders suffered a loss in excess of \$1,700,000.¹ The greater part of this loss probably fell on individual rather than institutional investors.² The increasing popularity of convertible issues³ makes it likely, if current redemption procedures are continued, that even greater losses will be sustained in the future.

Losses resulting from a failure to convert before redemption should not be regarded as an inevitable product of the investment process. The investor who suffers a loss because his stock depreciates has misjudged the market; his loss is of the essence of investment. But the holder of a convertible security who, because of redemption, loses the right to convert into stock worth considerably more than the security's face value suffers a loss of a different nature; his loss is brought about not by misjudgment but by failure to read a newspaper or to be at home to receive a letter. It results from unsatisfactory investment procedures, not from risks inherent in investment.

¹ Data compiled from a memorandum prepared for the SEC, on file in the Cornell Law Library. Had these holders made the conversion and sold the stock, the market might have been depressed, so that the indicated value could not have been realized. Adjustment must also be made for the small premium paid upon redemption. Still, the figures given should be substantially correct.

² The convertible securities market differs from the market for other corporate debt securities in that it is composed primarily of individuals. Kelly, *Basic Structure of the Corporate Bond Market*, 194 COM. & FIN. CHRON. 271, 292, col. 4 (1961); Levy, *Arbitrage, Convertible Bonds, and the Investor*, 194 COM. & FIN. CHRON. 278, col. 4 (1961).

³ Finn, *Mergers and Convertibles Stimulate Wall Street*, 206 COM. & FIN. CHRON., Oct. 26, 1967, § 2, at 8; Jones, *Hoogovens to Pechiney: Convertible Bonds are Winning New Favor in the European Market*, BARRON'S, March 1, 1965, at 5. On the attractiveness of convertibles to corporation and investor alike, see 1 A. DEWING, *THE FINANCIAL POLICY OF CORPORATIONS* 268-71 (5th ed. 1953); H. GUTHMANN & H. DOUGALL, *CORPORATE FINANCIAL POLICY* 85-86, 146-47 (3d ed. 1955); *Convertible Bonds—Two-way Attraction*, FIN. WORLD, Feb. 9, 1966, at 4; Levy, *supra* note 2; Mendes, *Convertible Debentures and Stock Options*, 206 COM. & FIN. CHRON. 442 (1967).

I

THE HOLDER'S LEGAL REMEDIES: CONSEQUENCES
OF AN ADHESION CONTRACT

A convertible bond or debenture is a contract between the issuer and the holder.⁴ One commentator argued, "The conversion privilege, being solely a matter of contract, may have such limitations and restrictions as the parties thereto may desire."⁵ However, this apparent suggestion that redemption and conversion terms of any sort are enforceable is incorrect. Courts have recognized that some terms of standardized contracts between parties of disparate bargaining power—contracts of adhesion⁶—should not be enforced.⁷

One court has defined an adhesion contract as follows:

[A] contract entered into between two parties of unequal bargaining strength, expressed in the language of a standardized contract, written by the more powerful bargainer to meet its own needs, and offered to the weaker party on a "take it or leave it" basis⁸

The contract between the issuer and the holder of a convertible security is an adhesion contract. The certificate and the indenture (the latter may be incorporated by reference into the certificate) are drafted by the issuer, the trustee, and the underwriter with their own interests in view.⁹ The individual purchaser has no opportunity to bargain with the drafters, since the securities are offered to the public on a mass basis. Even if there were such an opportunity, the drafters enjoy a much stronger bargaining position.¹⁰ The investor's only choice is to buy or not buy.

⁴ *Buchman v. American Foam Rubber Corp.*, 250 F. Supp. 60 (S.D.N.Y. 1965).

⁵ *Hills, Convertible Securities—Legal Aspects and Draftsmanship*, 19 CALIF. L. REV. 1, 15 (1930).

⁶ The term was apparently introduced into American legal literature by Professor Patterson. Kessler, *Contracts of Adhesion—Some Thoughts about Freedom of Contract*, 43 COLUM. L. REV. 629, 639 n.11 (1943); see Patterson, *The Delivery of a Life-Insurance Policy*, 33 HARV. L. REV. 198, 222 & n.106 (1919).

⁷ See, e.g., *Steven v. Fidelity & Cas. Co.*, 58 Cal. 2d 862, 377 P.2d 284, 27 Cal. Rptr. 172 (1962); Patterson, *The Interpretation and Construction of Contracts*, 64 COLUM. L. REV. 833, 858 (1964).

⁸ *Gray v. Zurich Ins. Co.*, 65 Cal. 2d 263, 269, 419 P.2d 168, 171, 54 Cal. Rptr. 104, 107 (1966).

⁹ Comment, *Protection for Debenture Holders*, 46 YALE L.J. 97, 98 (1936).

¹⁰ [T]he supposition is that the indenture evidences the intent of the security holders whose loans it secures. But that mutuality of intent which is assumed is in fact non-existent. To the extent that the indenture is the product of the borrower, the underwriter or the trustee, only their respective intents are reflected therein. It is no refutation of this to say that by voluntary purchase of his bonds, debenture

Because he is party to an adhesion contract, the holder whose right to convert has been terminated by redemption has at least two possible theories of recovery against the issuer. The first attacks the right of the issuer to terminate the conversion right, and the second attacks the sufficiency of the process by which termination is effected.

A. *Termination of the Conversion Right: Enforcing the Holder's Reasonable Expectations*

The right to convert into stock is central to the bargain between the holder and the issuer of a convertible security. Convertibles offer fixed interest rates and, if secured or offered by a corporation with a high credit rating, security, but these features alone would not attract investors; they can be obtained on better terms in other types of securities. Only the right to convert at an advantageous rate makes these relatively inferior terms acceptable. Thus, investment magazines advise purchasing the convertibles of certain companies because "each . . . is favorably situated for the longer term. That's important, for unless the stock has appreciation potential it hardly pays to buy the bond."¹¹

Because the conversion right was a major inducement to the purchase and because it is so important in determining the security's value, the holder of a convertible might well believe that it lasts for the stated life of the security.¹² This belief is confirmed by a title such as "4 1/2% Convertible Subordinated Debentures, Due 1981."¹³ The investor in convertible securities is usually an individual¹⁴ who is un-

tures or notes, the security holder accepts just so much as is given and no more. The individual purchaser of such security cannot normally bargain for special provisions. Nor can prospective buyers normally unite in anticipation of an issue, to exact desired terms. Inequality of bargaining power between investor and issuer is inherent in the very technique of security distribution.

SEC, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES pt. VI, at 5 (1936).

¹¹ *Convertible Bonds for Investment*, FIN. WORLD, Jan. 11, 1967, at 5.

¹² Most convertible issues have maturities of from 15 to 25 years. Kelly, *supra* note 2, at 292, col. 2.

¹³ The New York Stock Exchange recognizes that an inaccurate title can misinform the investor. NEW YORK STOCK EXCHANGE, COMPANY MANUAL § A12(I), *Securities Having Limited Conversion Rights*, provides:

In the case of a security having a right of conversion which is not exercisable through the entire life of the security, the word "convertible" shall not be used as part of the formal title of the security. Instead, attention shall be called to the conversion right by means of a sub-heading, such as "Convertible on or before . . ." or "Convertible on or after . . ."

Id. at A-217 (1966). Presumably this section does not apply to a security convertible through its entire life unless called.

¹⁴ See note 2 *supra*.

familiar with corporate financial practices;¹⁵ it is unrealistic to assume that he knows both that the issue is subject to redemption and that redemption terminates the right to convert. Indeed, the substantial losses sustained by failure to convert before the expiration of the conversion period discredit any such assumption.¹⁶ It is probable that many investors who have lost the right to convert entered the transaction with a misunderstanding of its terms.

If the holder has purchased a convertible security with the mistaken idea that it is convertible until the stated maturity, he will probably not be disabused. Although any one of three documents connected with the transaction—the indenture, the prospectus, and the certificate—might supply the needed information, the investor probably will see only one of these. The indenture almost certainly will not be seen.¹⁷ The prospectus will not normally be seen unless the security is bought as a new issue. Even if the prospectus for an older issue is available to the purchaser, it may not say that the right of conversion is terminable.¹⁸ The certificate may be seen by the investor, but may not sufficiently apprise him of the terms of his bargain; there is little about the certificate to induce him to read it.

An unqualified description of the security in the certificate's title as "convertible" discourages the holder from looking for qualifications in the text. Furthermore, the design of the certificate distracts the holder's attention from the text. Deterrence of forgers plays a large part in the design of a certificate,¹⁹ and accordingly its most prominent features are the margin, vignette, issuer's name, and title.²⁰ The text

¹⁵ See McKinlay, *Need for Legislative Control Over Public Debenture Borrowing*, 1966 N.Z.L.J. 59.

¹⁶ Undoubtedly many losses are attributable to simple failure to see the notice of redemption, the investor's knowledge notwithstanding. However, it is realistic to suppose that many notices are missed because people do not know that they should look for them.

¹⁷ *Hazzard v. Chase Nat'l Bank*, 159 Misc. 57, 60, 287 N.Y.S. 541, 545 (Sup. Ct. 1936). The trust indenture has been described as "a document that virtually no individual investors, and surprisingly few institutional analysts, ever read." A. BLADEN, *TECHNIQUES FOR INVESTING IN CONVERTIBLE BONDS* 14 (undated pamphlet, Salomon Bros. & Hutzler, New York City).

¹⁸ SEC Securities Act Release No. 4890, Item 33 (Dec. 20, 1967) provides in part:

Where a prospectus relates to convertible securities which are subject to redemption . . . it should be stated at an appropriate place in the prospectus that the right to convert . . . will be lost unless it is exercised before the redemption

¹⁹ See NEW YORK STOCK EXCHANGE, *COMPANY MANUAL* § A12(II), at A-219 (1963), *Printing and Engraving Requirements*, and A-220 (1963), *Vignettes*.

²⁰ See, e.g., the convertible debenture reproduced in *Specimens of Selected Securities* 7, found in R. STEVENS & H. HENN, *CASES ON CORPORATIONS* (1965).

may be printed in a small, heavily-leaded script²¹ which is partially obscured by a tint plate. Paragraphs may not be captioned or otherwise made to stand out. Thus, although the text is visible as a whole, it is neither conspicuous nor easily read.

In dealing with adhesion contracts, courts have recognized that "in view of the disparate bargaining status of the parties we must ascertain that meaning of the contract which [the weaker party] . . . would reasonably expect."²² Considering the importance of the right of conversion, the holder's ignorance, and the issuer's failure to make conspicuous the provision that the right is terminable, the provision is contrary to what the holder might reasonably expect. It should not be enforced. Thus, a court should refuse to allow the issuer to carry out a prospective termination or should award damages²³ to a holder where the issuer claims the right to convert is terminated. This enforcement of the holder's reasonable expectations could deprive the issuer of all power to terminate the conversion right. Arguably, this is a broader result than any court would be willing to achieve, but it would serve as a powerful impetus to the issuer to unequivocally apprise the purchaser of the terms of his bargain. Discouraging misleading expressions is an admitted goal of enforcing reasonable expectations in other types of adhesion contracts.²⁴

Courts have refused to enforce analogous insurance policy provisions. For example, in *Hessler v. Federal Casualty Co.*²⁵ a clause in fine print limited the insurer's liability to twenty percent of the policy's face value in case of death caused by intentional shooting. However, larger print on the back of the policy stated that "[this policy] covers all bodily injuries caused by accidental means, such as . . . gun shot wounds"²⁶ The insured was shot by a robber, and the issue was the amount of the company's liability. In holding the insurer liable for the full face value of the policy, the court stressed the insured's reasonable expectation based on the statement on the back of the policy and the company's failure to warn him of the limitation on its liability:²⁷

²¹ The New York Stock Exchange requires at least the promise to pay to be in script. NEW YORK STOCK EXCHANGE, COMPANY MANUAL § A12(I), at A-217 (1966), *Bonds in Definitive Form*, *id.* § A12(II), at A-220 (1963).

²² *Gray v. Zurich Ins. Co.*, 65 Cal. 2d 263, 270, 419 P.2d 168, 171-72, 54 Cal. Rptr. 104, 107-08 (1966) (footnotes omitted). See *Kessler*, *supra* note 6, at 637.

²³ See pp. 281-82 *infra*.

²⁴ See, e.g., *Steven v. Fidelity & Cas. Co.*, 58 Cal. 2d 862, 879-84, 377 P.2d 284, 295-98, 27 Cal. Rptr. 172, 183-86 (1962).

²⁵ 190 Ind. 68, 129 N.E. 325 (1921).

²⁶ *Id.* at 70, 129 N.E. at 325.

²⁷ Although *Hessler* and the other cases discussed in the text ostensibly were decided

[T]he unequivocal statement on the back of the policy, presented in a manner to catch the eye of the insured, . . . expressly referred to in the opening lines of the policy . . . , forbids that a limitation which purports to reduce the amount of liability . . . hidden away in small type, . . . without further headline, . . . shall receive a construction that will defeat the recovery in this case of all but twenty per cent. of the face of the policy.²⁸

In *New York Life Insurance Co. v. Hiatt*²⁹ the issue was whether double indemnity was payable when the insured died of gas inhalation. The cover of the policy was stamped "Double Indemnity for Fatal Accident," but a clause on the fifth page provided that double indemnity was not payable if, among other things, death was caused by gas. The court rejected the insurer's contention that the stamped phrase was too brief to be given substantive effect³⁰ and held that double indemnity was payable. It pointed out that the insurer could easily have called insured's attention to the limitation³¹ and that a contrary holding would not promote "fair speaking" in insurance policies.³²

*Mohan v. Union Fidelity Life Insurance Co.*³³ dealt with the benefits payable when the insured sustained compensable injury. An endorsement to the policy stated in bold letters, " 'PAYCHECK-PLUS' SICKNESS AND ACCIDENT BENEFIT ENDORSEMENT." Although the policy provided monthly benefits of two hundred dollars, the court held the insurer liable for insured's monthly wages of \$450, noting that the policy was sold on a mass basis with little chance for

on grounds of construction and interpretation, a reading of the opinions makes clear that the courts are actually enforcing the policy holders' reasonable expectations. "This process of interpretation was used many years ago in interpreting (or construing) insurance contracts." Patterson, *supra* note 7, at 858 (footnote omitted). See *New York Life Ins. Co. v. Hiatt*, 140 F.2d 752, 753-54 (9th Cir. 1944); *Hessler v. Federal Cas. Co.*, 190 Ind. 68, 76, 129 N.E. 325, 327 (1921); *Mohan v. Union Fidelity Life Ins. Co.*, 38 Pa. D. & C.2d 401, 410-12 (C.P. 1965), *aff'd*, 207 Pa. Super. 205, 216 A.2d 342, 347-48 (1966) (lower court opinion reproduced in 216 A.2d 342).

²⁸ *Hessler v. Federal Cas. Co.*, 190 Ind. 68, 75, 129 N.E. 325, 327 (1921).

²⁹ 140 F.2d 752 (9th Cir. 1944).

³⁰ *Id.* at 753. But see *Kraus v. Laclede Gas Co.*, 354 S.W.2d 327 (Mo. Ct. App. 1962), where it was argued that an issuer of securities could not enforce redemption provisions appearing in fine print when the security was captioned "4½% Fifteen Year Convertible Sinking Fund Debentures." The court did not agree; it said that the caption was only a general description and could not be thought to express the whole of the agreement. No cases were cited. Cases like *Hiatt*, where the insurance policy was at least five pages long, however, indicate that it is not necessary that the title purport to be the whole of the agreement; it is enough that the title have implications which are not adequately denied elsewhere.

³¹ 140 F.2d at 753.

³² *Id.* at 754.

³³ 38 Pa. D. & C.2d 401 (C.P. 1965), *aff'd*, 207 Pa. Super. 205, 216 A.2d 342 (1966).

negotiation³⁴ and that the title was a powerful attraction to the purchaser.³⁵

These cases can furnish precedent for a refusal to enforce a clause in a convertible security allowing the issuer to terminate the holder's right of conversion before the issue's stated maturity. Both the issuer and the insurer attempt, without adequate warning, to limit or qualify rights which go to the heart of the bargain and which their security or policy holders might reasonably expect to have.

Arguably, the problems are distinguishable because the disappointed insured could easily have obtained the desired coverage, while the investor cannot purchase a convertible security without redemption provisions.³⁶ The policy holder is thus disappointed because he has inadequate knowledge of his particular policy's contents, whereas the security holder is disappointed because he is ignorant of a feature found in all convertible securities. Thus, because the contract did not lead the holder astray, it may be pointless to apply to securities a remedy intended to promote clear contractual statements of limitations on the right to convert.³⁷ However, this argument ignores the effect of industry practice. The issuer discourages the holder from looking for qualifications by distributing convertible securities under titles which contain the word "convertible" and by failing to provide anything which calls the holder's attention to qualifications on the right to convert. The

³⁴ 38 Pa. D. & C.2d at 410, 216 A.2d at 347.

³⁵ "The simple thought is the plain thought that the policy will pay the 'paycheck'." *Id.* at 411, 216 A.2d at 348 (footnote omitted).

³⁶ Kelly, *supra* note 2, at 292, col. 2.

³⁷ The distinction and the argument are perhaps given weight by *Mohan v. Union Fidelity Life Ins. Co.*, 38 Pa. D. & C.2d 401 (G.P. 1965), *aff'd*, 207 Pa. Super., 205, 216 A.2d 342 (1966), discussing *Continental Gas. Co. v. Trenner*, 35 F. Supp. 643 (E.D. Pa. 1939). In *Trenner* one clause of an automobile insurance policy was captioned "Automatic Insurance for Newly Acquired Automobiles." The clause provided that there was no coverage for liabilities incurred more than ten days after the car was acquired unless the company had been notified of the acquisition within ten days of the date of purchase. The district court rejected an argument based on the caption, holding that there was no coverage of an accident occurring more than ten days after the car was acquired where the insured had not notified the company. The court in *Mohan* distinguished *Trenner* on the ground, not mentioned by the district court, that "notice is a prime and not uncommon requisite in an insurance policy." 38 Pa. D. & C.2d at 407, 216 A.2d at 346. Thus *Mohan* arguably stands for the proposition that reasonable expectations should be enforced only when they are not contrary to an industry practice. On the other hand, *Mohan* may stand for enforcing expectations only where they are reasonable, and, because the need for notice is a matter of common knowledge, *Trenner's* expectations were not reasonable. On this view, whether the holder's expectations should be enforced depends on whether it is common knowledge that the conversion privilege is terminable. It is urged herein that it is not common knowledge.

contract and the manner of distribution may not engender the holder's expectations, but they confirm them.

Insurance policies and convertible securities are both contracts of adhesion. Protection of the weaker party and recognition of a public interest in insurance are reasons which have motivated the courts to afford special treatment to insurance policies.³⁸ Similar reasons are equally compelling in the area of securities; the holder of a convertible security is in no better bargaining position than the holder of an insurance policy, and the public interest in securities is evidenced by extensive regulation of that field.³⁹ If the insurer must make clear to his insured any limitations on coverage, the issuer of convertible securities should similarly apprise the holders of any limitations on the right of conversion.

B. *Notification Procedures: Refusing to Enforce an Unconscionable Bargain*

The usual procedure for notifying holders of coupon bonds of an impending redemption is publication of a notice once a week for four weeks in a New York City newspaper.⁴⁰ The time when the first publication must be made varies from thirty to sixty days before the redemption date.⁴¹ Holders of registered securities, on the other hand, are usually notified by mail,⁴² but the indenture may provide that if notice is also given by publication, "neither failure to give notice by mail, nor defect in any notice so mailed, shall affect the validity of the proceedings for such redemption."⁴³ Similar provision may be made

³⁸ See *Steven v. Fidelity & Cas. Co.*, 58 Cal. 2d 862, 377 P.2d 284, 27 Cal. Rptr. 172 (1962); Kessler, *supra* note 6, at 633, 635.

³⁹ Arguably, because he needs insurance but does not need to invest, the individual should be protected in the purchase of insurance but not in the purchase of securities. But a capitalistic economy requires investment, and protection of the individual encourages investment.

⁴⁰ See, e.g., AMERICAN BAR FOUNDATION CORPORATE DEBT FINANCING PROJECT, MODEL DEBENTURE INDENTURE PROVISIONS § 1105 (1965); R. McCLELLAND & F. FISHER, JR., THE LAW OF CORPORATE MORTGAGE BOND ISSUES 543 (1937); *Specimens of Selected Securities*, *supra* note 20, at 7. A newspaper published in another city is sometimes used as well. See, e.g., *Kraus v. Laclede Gas Co.*, 354 S.W.2d 327 (Mo. Ct. App. 1962); AMERICAN BAR FOUNDATION CORPORATE DEBT FINANCING PROJECT, *supra*.

⁴¹ AMERICAN BAR FOUNDATION CORPORATE DEBT FINANCING PROJECT, *supra* note 40, § 1105; McCLELLAND & FISHER, *supra* note 40, at 543; *Specimens of Selected Securities*, *supra* note 20, at 7.

⁴² Issuers do not always make use of this opportunity. A registered security may provide that notice by either publication or mail is sufficient. See, e.g., *Specimens of Selected Securities*, *supra* note 20, at 7.

⁴³ AMERICAN BAR FOUNDATION CORPORATE DEBT FINANCING PROJECT, *supra* note 40, § 1105.

for failure to comply exactly with the publication requirements.⁴⁴ Finally, the notice published or mailed to the holder may not mention that the right to convert is terminated by redemption.⁴⁵

With the exception of notifying the holder by mail, these procedures entail a high probability that a holder will not be notified. For this reason, the procedures should be deemed unconscionable.⁴⁶ Inclu-

⁴⁴ See McCLELLAND & FISHER, *supra* note 40, at 543 n.

⁴⁵ The American Bar Foundation's 1965 model indenture provisions had no requirement that notices of redemption include a statement that redemption terminates the right to convert; the 1967 version does have this requirement. AMERICAN BAR FOUNDATION CORPORATE DEBT FINANCING PROJECT, SAMPLE INCORPORATING INDENTURE art. 13(6) (1967).

There may be notice requirements in addition to those in the indenture. See, e.g., NEW YORK STOCK EXCHANGE, COMPANY MANUAL § A10 (1967), which requires that news of corporate action looking towards redemption be released to a New York City newspaper, Dow Jones, and a major wire service. A general news release, rather than a formal advertisement, satisfies this requirement, and repeated publication is not necessary. These requirements do not significantly improve the quality of notice given the holder.

⁴⁶ The classic definition of "unconscionable bargain" is that given in *Earl of Chesterfield v. Janssen*, 28 Eng. Rep. 82 (Ch. 1751): "[Bargains] such as no man in his senses and not under delusion would make on the one hand, and as no honest and fair man would accept on the other . . . are unequitable and unconscientious . . ." *Id.* at 100. This definition was adopted in *Hume v. United States*, 132 U.S. 406, 411 (1889), and in *Greer v. Tweed*, 13 Abb. Pr. (n.s.) 427, 429-30 (N.Y.C.P. 1872). In *Williams v. Walker-Thomas Furn. Co.*, 350 F.2d 445 (D.C. Cir. 1965), the court set up the following standard:

Unconscionability has generally been recognized to include an absence of meaningful choice on the part of one of the parties together with contract terms which are unreasonably favorable to the other party. Whether a meaningful choice is present in a particular case can only be determined by consideration of all the circumstances surrounding the transaction. In many cases the meaningfulness of the choice is negated by a gross inequality of bargaining power. The manner in which the contract was entered is also relevant to this consideration. Did each party to the contract, considering his obvious education or lack of it, have a reasonable opportunity to understand the terms of the contract, or were the important terms hidden in a maze of fine print and minimized by deceptive sales practices?

Id. at 449 (footnotes omitted).

The power of American courts to refuse to enforce an unconscionable contract provision has been expressly recognized by both statute and case law. See *Williams v. Walker-Thomas Furn. Co.*, *supra*; *Henningsen v. Bloomfield Motors, Inc.*, 32 N.J. 358, 161 A.2d 69 (1960); UNIFORM COMMERCIAL CODE § 2-302. When applied to adhesion contracts, the power has been rationalized as a necessary response to situations where there is no meaningful choice. *Henningsen v. Bloomfield Motors, Inc.*, *supra*; see *Patterson*, *supra* note 7, at 855-58. The prospective purchaser cannot find a convertible security without provisions for redemption. Kelly, *supra* note 2, at 292, col. 2. However, he does have an initial choice whether to invest at all. He has a secondary choice whether to buy a coupon or a registered issue, which is in effect a limited choice of notice provisions. His position is therefore not the same as that described in *Henningsen*, where the court found that the purchaser of an automobile had no real choice as to warranties because all manufacturers used the same warranty and because, as a practical matter, the purchaser had to have a car. 32 N.J. at 386-87, 390, 161 A.2d at 85, 87. However, courts may also find a form contract clause to be unconscionable where the contract is for the sale of a non-essential

sion of a conversion feature in a security works to the issuer's advantage,⁴⁷ since convertibility makes salable an issue which would not otherwise be so⁴⁸ and gives any issue appeal to a broader cross-section of investors than it would otherwise have.⁴⁹ The issuer of a convertible borrows money at a lower rate of interest than a straight bond or debenture would require and, if conversion is made, in effect sells stock at a higher price than was obtainable at the time the convertible was issued. It is unfair for the issuer to use the conversion right to its own advantage, and then to withdraw that right in such a way that a holder is unlikely to receive any warning and, hence, is unlikely to benefit from the right.

It is questionable how many convertible securities would be bought if potential purchasers were aware of the likelihood of not receiving notice of a redemption. A holder who does not receive notice is left, on balance, with the disadvantages of his bargain. He receives interest (although at a lower rate than he could have had without the right to convert), the redemption premium, and repayment of principal, but he loses the stock into which his holdings are convertible and its value, which is likely to be considerably greater than the value of what he retains.⁵⁰ Here there is not the double wrong of, say, an exorbitant profit,⁵¹ but the lack of unjust benefit to the issuer does not mitigate the harm done to the holder. Of course, as long as bearer or unregistered securities are issued, no procedure can guarantee that every holder will be notified. But improved procedures could be adopted. For example, publication could be made more frequently in a greater number of papers. These papers could be specified by name, rather than by city of publication, and could be selected so that in any part of the country at least one would be easily available. Rather than providing simply that publication will be made sometime during the week, the day could be specified. Furthermore, since redemption dates are usually made to coincide with interest dates, thereby

and where there is no suggestion that better terms are not available elsewhere. *Williams v. Walker-Thomas Furn. Co.*, *supra*.

Because a plea of unconscionability could be made only after the right to convert had been terminated, and then only by a holder who did not in fact receive notice, this theory has a narrower effect than does enforcement of the holder's reasonable expectations. See pp. 275-78 *supra*.

⁴⁷ 1 DEWING, *supra* note 3, at 271.

⁴⁸ GUTHMANN & DOUGALL, *supra* note 3, at 146.

⁴⁹ 1 DEWING, *supra* note 3, at 271.

⁵⁰ See note 55 and accompanying text *infra*.

⁵¹ See, e.g., *American Home Improvement, Inc. v. MacIver*, 105 N.H. 435, 201 A.2d 886 (1964). Indeed, the holder's failure to convert appears contrary to what the issuer wants; see note 55 and accompanying text *infra*.

avoiding bookkeeping problems,⁵² a requirement that notice be published on, as an example, the four Mondays immediately preceding the redemption date would not unduly restrict the issuer's discretion. Certainly any notice given should make clear that the right of conversion is about to be terminated.

Arguably, no method of publication will notify substantially more investors than are reached under existing procedures. If so, the issuer's failure to improve its publication practice is no basis for holding present procedures unconscionable.⁵³ But if the issuer can provide a practicable substitute for publication and does not do so, its continuing use of publication does provide such a basis. A substitute is available; the issuer can either solicit addresses to which notices could be mailed or, as is sometimes done, give the holder the option of registering his bond.

These suggested procedures would increase the probability that a holder would receive notice of redemption, yet would place only a relatively light burden on the issuer. Even the expense of publishing more often in more newspapers is slight in comparison with the losses currently sustained by investors. Compared to the suggested procedures, existing procedures seem careless of the holder's rights. Indeed, the provisions regarding notice given without strict compliance with the indenture's terms suggest that present procedures are designed not so much to notify the holder as to present as few barriers as possible to an effective redemption when the issuer wants to redeem. Considering the importance of the right of conversion to the holder, the issuer drives too hard a bargain in the matter of notice.

C. *Damages*

Were a court to hold either that the reasonable expectations of the holder cannot be disappointed without a more conspicuous warning or that the provisions for giving notice are so unsatisfactory in the

⁵² Mendes, *supra* note 3, at 442, col. 3.

⁵³ There is an obvious analogy to notice by publication in legal actions. Arguably, the notice provisions in the indenture should not be held unconscionable unless they are markedly inferior to typical statutory requirements. This is not generally the case; *see, e.g.,* N.Y. CIV. PRAC. LAW § 316(a) (McKinney 1963). However, notice by publication has fallen into disfavor; *see* F. JAMES, JR., CIVIL PROCEDURE § 12.11, at 652-53 (1965). In some situations where such notice is permissible, it is expected that the person to be notified will receive notice as a result of some other action, such as attachment or garnishment. *Mullane v. Central Hanover Trust Co.*, 339 U.S. 306, 316 (1950). In others "it is not reasonably possible or practicable to give more adequate warning." *Id.* at 317. Neither of these situations exists in the case of convertible securities; there is nothing to notify the holder except the notice given, and the issuer could easily provide a means of notice better calculated to reach the investor.

circumstances as to be unconscionable, the issuer's refusal to convert after the redemption day would be wrongful. Since the stock is probably not unique and since the issuer's refusal to convert works no irreparable harm to the holder, specific performance is probably not available. What damages, then, should the holder be awarded?

One court has suggested that, failing a proper exercise of the power to redeem, the rights between issuer and holder continue as before.⁵⁴ This implies that the proper measure of damages is the value, at the time of refusal, of the stock into which the security is convertible. Unless the value of the stock is then the same as on the last day the issuer allowed conversion, however, this measure is unsatisfactory.

If the stock has appreciated since the redemption day, the holder is elevated above those holders who converted within the time allowed and have since sold the stock. Furthermore, litigation is encouraged by making it profitable to wait and challenge the redemption. Arguably, the holders who converted could have retained the stock and enjoyed the fruits of its appreciation, but the holder who successfully presents his claim in court had, while he waited, the security of a fixed claim against the issuer which the other holders lacked. *Vis-à-vis* the issuer, the holder is entitled to compensation, but he should not be put in a position superior to that of other holders.

If the stock has depreciated since the last day for conversion, a measure of damages giving the holder the lesser value in effect punishes him for an omission which is either reasonable or the result of unsatisfactory notice procedures. Again, of course, a holder who converted before the end of the conversion period might have retained the stock and suffered the same loss; but he was aware of the absence of any fixed claim against the issuer and made a conscious decision to retain the stock, whereas the holder who thought he had a claim had no such opportunity.

The best approach is to award the holder the market value of the stock on the last day of the conversion period. If the stock has appreciated since that time he is denied the increased value. But since he avoided the investment risk undertaken by holders who converted and retained the stock, he can fairly be denied the additional amount.

II

NON-LEGAL REMEDIES: ENTERPRISE REFORM

Failure to notify investors creates ill will and loss of faith in investment generally; furthermore, it frustrates the issuer's attempt to force

⁵⁴ *Mueller v. Howard Aircraft Corp.*, 329 Ill. App. 570, 578, 70 N.E.2d 203, 207 (1946).

conversion so as to avoid a drain on his funds.⁵⁵ A better system should be devised. Legal enforcement of a holder's conversion right after redemption could probably be prevented by simple changes in the drafting and appearance of convertible securities. Although such changes are desirable, they will not eliminate the problem. No system depending on notice to the investor can insure a complete absence of losses.

Although the industry recognizes that a problem exists, it apparently feels that the loss is either too insignificant to merit change or the result of carelessness on the investor's part and hence not susceptible to cure.⁵⁶ A \$1,700,000 loss⁵⁷ is significant, however, in individual if not in corporate terms, and investor carelessness in this regard is a problem only if the investor is required to be alert. There may be satisfactory alternatives which do not make such demands on the investor.

Adoption of some or all of the suggested changes in notification procedures would be an improvement, but it would not help the investor who does not realize that the issuer may try to reach him. Issuing all convertible securities in registered form would allow all holders to be reached by mail. But despite a movement in favor of registered bonds,⁵⁸ technological improvements in the handling of coupons and objections based on the delay inherent in the transfer of registered securities make a complete changeover unlikely.⁵⁹ Holders of coupon bonds could be invited to send the issuer an address to which notices would be sent; again, however, the problem of how to inform the unwary investor of this opportunity remains.

A more positive solution is to give the trustee authorization in the indenture to requisition and sell, at the close of the conversion

⁵⁵ BLADEN, *supra* note 17, at 14; Kelly, *supra* note 2, at 292, col. 2. In theory, the issuer will redeem only when the market price of the stock is sufficiently greater than the conversion price to make conversion the holders' only reasonable alternative. If the difference between the market price of the stock and the redemption price is small enough to cause doubt whether nearly all holders will convert rather than redeem, it is standard practice to enter into a standby agreement with underwriters. The issuer pays the underwriter to offer to buy, at a premium over the redemption price, those securities which holders choose not to convert. The underwriter then converts the securities.

⁵⁶ One authority on convertible securities says, somewhat incredulously, "In spite of the wide publicity that corporations give to convertible bond calls, thousands of investors every year fail to convert or tender their bonds. Don't let this happen to you!" BLADEN, *supra* note 17, at 12.

⁵⁷ Note 1 and accompanying text *supra*.

⁵⁸ See, e.g., Ely, *The Campaign for Registered Bonds*, PUB. UTIL. FORTNIGHTLY, April 25, 1963, at 46; Johnson, *Toward a More Widespread Use of Registered Bonds*, 198 COM. & FIN. CHRON., July 11, 1963, § 2, at 11.

⁵⁹ Waldbillig, *Coupon Bonds Still Preferred to Registered by Many Investors*, 199 COM. & FIN. CHRON. 1013 (1964). Agnew, *Solving Bond Coupon Problem*, 198 COM. & FIN. CHRON., July 11, 1963, § 2, at 10.

period, a number of shares equal to the number for which debentures still outstanding could have been exchanged.⁶⁰ The sale would be made only if its net proceeds were greater than the redemption price of the still outstanding securities. A holder of unredeemed or unconverted debentures would then receive his pro rata share of the net proceeds, rather than the redemption price. This solution sidesteps completely the problem of the careless and the unreachable investor.

The utility of the trustee's sale is not limited to future convertible issues, for the issuer and the trustee of an existing issue could enter into an agreement adopting this method. There would be little difficulty in making such an agreement; since the holders would benefit, their consent would probably be unnecessary.⁶¹ Arguably, however, making the agreement would breach management's duty to obtain at least a reasonable price for corporate assets.⁶² The trustee could sell the shares in such a way as to obtain their market value for the company; instead, he sells them and holds the proceeds for the security holders, thereby obtaining only the conversion price. Thus, the agreement may waste corporate assets. However, the trustee's sale is distinguishable from the ordinary sale of corporate property in that the shares involved are exclusively those to which the security holders had a prior claim. The sale merely insures that the security holders will benefit from their right to convert.

Although the shares are sold after the expiration of the holder's claim to them, the issuer is under no obligation to terminate conversion rights at a specified time; the conversion period could extend until the issues' maturity date. Thus, the relationship between the time of the sale and the end of the conversion period should be irrelevant. Furthermore, insofar as the agreement adopting the trustee's sale forestalls litigation of either the validity of terminating the right to convert or the adequacy of notice, it is a valid exercise of management's power to settle disputed claims.⁶³

⁶⁰ An additional statutory exemption from the registration requirements of the Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1964), would be required. There is no reason to think the SEC would not be in accord with this exemption.

⁶¹ Indentures commonly provide that modifications for the benefit of the holders can be made without their consent. *See, e.g.*, AMERICAN BAR FOUNDATION CORPORATE DEBT FINANCING PROJECT, *supra* note 40, § 901(2); 3A FLETCHER CORPORATION FORMS ANNOTATED § 2853.1, at 223 (rev. 3d ed. 1958); McCLELLAND & FISHER, *supra* note 40, at 818. Such modifications could also be made without any express authority in the indenture. J. KENNEDY, CORPORATE TRUST ADMINISTRATION 222 (1961).

⁶² *Gomberg v. Midvale Co.*, 157 F. Supp. 132 (E.D. Pa. 1955); *Schmid v. Lancaster Ave. Theatre Co.*, 244 Pa. 373, 91 A. 363 (1914).

⁶³ *Levine v. Behn*, 174 Misc. 988, 21 N.Y.S.2d 805 (Sup. Ct. 1940), *aff'd*, 262 App. Div.

The method of the trustee's sale might be generally attacked on the ground that under it only a few investors would convert, most choosing to await the proceeds of the sale. The simple failure to convert would not, however, harm the issuer, since it would produce no drain on the issuer's funds. The only difficulty arising from wholesale nonconversion would be that the large sale by the trustee would realize much less than could be obtained under the present system, thereby reducing the relative attractiveness of convertible debentures. But it is not clear why the new system would produce an increased number of failures to convert. Holders who wanted the stock, rather than its proceeds, would still convert; even holders who intended to sell the stock would surely convert rather than take their chances in the sale. In most cases, then, investor behavior would follow its present pattern. The crucial difference would be that holders who are unaware of the redemption would be spared most of the loss they now suffer.

David P. Lampkin

729, 28 N.Y.S.2d 711 (1st Dep't 1941); *Hurley v. Ornstein*, 311 Mass. 477, 42 N.E.2d 273 (1942).